Accounting Historians Journal

Volume 24
Issue 2 *December 1997*

Article 3

1997

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The Accounting Historians Journal
Vol. 24, No. 2
December 1997

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DEFINING AUDITORS' RESPONSIBILITIES

Abstract: This paper explores the efforts of the audit profession to dominate definitions of their roles and responsibilities throughout the last two decades. The paper considers alternative definitions of these roles and responsibilities as forwarded by others and the justifications and defenses provided by auditors to legitimize their conceptions of these matters.

The U.S. auditing profession maintains that its work enhances the reliability and credibility of financial statements and thereby facilitates the operation of capital markets. Although the profession has benefitted greatly from legislated requirements for annual audits, it has also fought forcefully to dominate the definitions of its tasks, roles, and responsibilities—to perform audits as it sees fit. In developing and maintaining a particular position relative to their responsibilities in conducting financial audits, auditors have attempted to tell the public whom they serve as well as the types of tasks that the public may reasonably expect the profession to undertake.

This insistence upon a self-definition of tasks, roles and responsibilities should not be surprising. With the passage of the securities acts and licensing statutes by individual states, auditors have demarcated the attestation of financial statements as an element of their professional jurisdiction. Through such demarcations, professions attempt to gain legitimate control over particular kinds of work [Abbott, 1988]. They claim the right to perform work within their jurisdiction as they deem appropriate and also to dominate public definitions of their professional tasks. In effect, professions are asking the public to trust that they know best how to define their professional roles and responsibilities and how to accomplish their professional tasks. Carmen Blough [1939, p. 165] succinctly captured this position in discussing why auditors should refer to audit

Submitted November 1996
Revised April 1997
Accepted September 1997

procedures "deemed" appropriate rather than exhaustively listing the procedures performed during an audit in the audit certificate (i.e. report):

> [These words] say 'You must trust me to do a good job as an accountant. No detailed recital that I might make of the auditing procedures followed would tell you enough to make it worth your while to read them. If you cannot trust me, you had best not depend upon my certificate, but if you can bring yourself to the frame of mind where you believe I will do what an honest, capable and independent public accountant should do, then you may rely upon it.'

In exchange for defining its professional work and responsibilities, however, a profession must also be seen to perform the work defined as contained in its jurisdiction. In other words, an obligation is imposed upon a profession to do what it says it will do. For some professions, this obligation is perhaps difficult to monitor. For example, do lawyers actually serve the needs of justice, their primary jurisdictional claim [Abbott, 1988].[1] For other professions such as auditing and accounting, "failures" to accomplish professional work may be highly visible and the definition of a "failure" contested.

Audits are seen to fail. Indeed, the history of auditing might be interpreted by some as a history of auditing failures [Power, 1992]. But when is an audit to be described as a failure, and when do such failures suggest weaknesses in auditing practices or failures by the auditing profession more generally? Are sudden and unexpected corporate bankruptcies evidence of an audit failure? What of the failure to detect material fraud? When may audits described as failed be interpreted to imply the roles and responsibilities of auditors should be redefined? The answers to these questions no doubt depend upon to whom they are addressed.

The significances or meanings to be attached to an audit opinion, the only visible sign that audit work has been performed, remain ambiguous. Does a "clean" report imply that fraud was absent or that no fraud was detected? Can one infer from a "clean" report that a corporation is financially sound and can be expected to continue its operations into the future? Or does a "clean" report refer only to the use of GAAP in constructing financial statements? Each (or all) of these meanings may be and have been assigned to the "clean" audit report. Yet, they carry

[1] This claim is also being increasingly contested in recent years.

significantly different implications for the roles and responsibilities of the auditor. If a "clean" report is interpreted to mean no fraud is present, then the auditor has a responsibility to detect fraud, to search actively to find it. If it implies only that no fraud was detected, then the auditor may not be seen as responsible for searching for fraud. If the report is interpreted to imply that a company will continue to exist, then the auditor must assess its future viability before issuing a report.

In recent decades, considerable attention has been given to the existence of an "expectations gap" between what "the public" believes auditors should do and how auditors have defined their roles and responsibilities. Disagreement and controversy have surrounded the significance and content to be accorded the term "auditors'"roles and responsibilities". This gap has been explored in the accounting literature. For example, Humphrey et al. [1992] have critically examined the response of the profession to this gap, primarily in the UK context. Hooks [1991] has considered efforts to match public concerns with auditor actions, and suggested that the profession may benefit from public ignorance. These and other authors have raised questions regarding whether auditors act in the public interest when they adhere to extant standards rather than assess the economic consequences of audited transactions [Merino & Kenny, 1994; Martins & McEnroe, 1992]; when they respond to public outcries in particular ways [Fogarty, 1996; Byington & Sutton, 1991; Mills & Bettner, 1992] or even whether they meet their own definitions of serving the public interest [Sikka et al., 1989]. In this paper, I hope to make a modest contribution to this literature by examining the efforts of the U.S. accounting profession to dominate definitions of its roles and responsibilities during the last three decades. These efforts have occurred amidst tension between the perceived obligations of auditors to perform particular tasks and their declared "rights" to define such tasks. In part, this tension has arisen from the particular cultural values [Abbott, 1988] with which auditors have aligned their work. The next section briefly considers some of these values in an historical context and the justifications employed by auditors to legitimize their work. It also outlines the ways that auditors defined their professional tasks during the 1970s. In the subsequent sections, I consider the challenges that have been posed to these definitions and the responses of auditors to these challenges, from the 1970s to the 1990s. The final section contains some concluding observations.

WHY ARE FINANCIAL AUDITS "VALUABLE"?

In the 1970s, auditors described their role as one of enhancing the credibility of financial information and furthering the operations of an effective capital market [Carmichael, 1974]. This claim bears a striking resemblance to those made in the 1930s regarding the necessity for enhanced financial disclosure by corporations. Prior to the 1930s, corporations were required neither to submit annual reports to government agencies or shareholders nor to have such reports audited. Corporate managers "regarded their company's affairs as private and privileged" [McCraw, 1984, p. 166].[2] Indeed, "Mystery [i.e. nonreporting] was treated as an asset, on the grounds that publicity would be too informing to competitors" [Ripley, 1927, pp. 178-179]. During the economic depression, corporate secrecy was increasingly seen as a threat to the functioning of capitalism undermining the legitimacy of the securities industry [McCraw, 1984]. For some, the "worst damage" of the Depression was the "wholesale betrayal of confidence by investors" [Andrews, 1932, p. 354], including "unrestrained financial exploitations which create[d] fictitious values never justified by earnings" [Roosevelt, 1933, p. 226].

Regaining investor confidence was deemed essential to the economic recovery of the U.S. [Roosevelt, 1933], and enhanced disclosure by corporations was seen as one means to this end. It was in this climate of economic depression and distrust that the 1933 Securities Act ("Truth in Securities") was enacted. The act was described as a response to "the reticence of financiers" [Rep. Rayburn, quoted in McCraw, 1984, p. 166], and required that specific disclosures accompany the issuance of new securities. The 1934 Securities and Exchange Act extended these disclosure requirements to encompass all publicly traded companies and established the Securities and Exchange Commission. The New Deal legislation also required that the disclosures and reports submitted by corporations be audited. These audits would enable a new era of "caveat vendor" [Andrews, 1932, p. 359], supplanting that of *caveat emptor* which had been prevalent in previous decades. After all, "it is generally regarded that an independent audit of any business is a good thing" [Col. Carter during Congressional hearings on the Securities Act, quoted in Carey, 1960, p. 187]. Through enhanced disclosure, audit, and other practices, confidence and trust were to be restored in the operations of

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[2] Also see Ripley [1927] and Robbins [1929].

the securities markets.[3] The practice of auditing was thus closely linked to the cultural value of credible financial reporting seen as necessary for the securities markets.

In the 1970s, audits were still described as affirming the truthfulness of financial statements and ensuring that financial statements were "fairly presented" [Palmer in *New York Times*, April 6, 1975]. This function was loosely linked to various audit practices including the review and testing of company records and the procedures and controls used to assemble financial information, approval of the use of various accounting principles, and examination of financial statements to ensure they contained no material misstatements, omissions, or misleading presentations of data [Silverman, 1971]. Through the application of such practices, the auditor was to render a professional opinion "as to the reliability of a company's financial records. . . .judged in terms of the adequacy of records from which the information emanates and the acceptability of technical accounting principles involved in recording transactions" [Silverman, 1971]. In describing their role in this way, auditors maintained that the purpose of an audit was to ensure that financial statements fairly presented the financial position and condition of a business entity and that the notion, "fairly presented", was a function of the acceptability of various accounting principles. The audit profession did not accept responsibility for the preparation of financial statements. Instead, these statements were declared to be the representations of management and the responsibility of management [Mautz and Sharaf, 1961].[4]

The terms used to describe the auditors' role were quite ambiguous—ensuring "fair presentation" and the "truthfulness" of financial reporting. While such ambiguity serves to suggest the expertise and knowledge required to conduct an audit properly through the exercise of professional judgment [Power, 1992], it also increases the possibility of multiple and conflicting interpretations of these terms as well as multiple and conflicting assessments as to whether auditors had accomplished these ends in specific instances. What obligations did the profession maintain were undertaken by auditors? Could financial statements be described as "fairly presented" when an auditor failed to

[3]See Neu [1991a, b] re: trust production in the Canadian securities industry.

[4]This statement echoes an opinion of the SEC which maintained that the "fundamental and primary responsibility for the accuracy of information filed with the Commission rests upon management" [quoted in Montgomery, 1940, p.135].

detect fraud? With fraud, revenues and assets might be overstated or expenses and liabilities understated. If information about these accounting categories could be said to represent the financial condition and operations of an entity but the categories themselves were "inaccurate," then could one argue that the financial statements fairly presented the operating results and financial condition of the entity? Did the term "fairly present" which appeared in the standard audit opinion imply that financial statements were free of material errors resulting from fraud or other illegal acts?

Prior to the passage of the securities acts, the primary purpose of an audit was to "ascertain the actual financial condition and earnings of an enterprise," with the minor object of detecting and preventing fraud and errors [Montgomery, 1921-22, pp. 19, 21, and 1927, pp. 23, 25]. However, by 1940, the detection of fraud was no longer described as an object of the audit, as this would "require an examination of such detail that its cost ... would be prohibitive" [Montgomery, 1940, p. 13].[5] By the late 1940s, it was argued that audits were not designed to detect fraud, nor were auditors responsible for its detection [Montgomery, 1949; Kohler, 1947].

Throughout the 1970s, auditors continued to maintain that the concept of "fairly present" as defined by the profession imposed a very limited obligation upon auditors to detect fraud or other illegal acts. Some argued that it was "sheer ignorance to think the purpose of the audit is to detect fraud" and, in their engagement letters with corporate management, audit firms often included explicit statements to indicate they were not in the business of detecting fraud [Hershman, 1974; Blinn, 1977]. According to the professional literature of the time, auditors were responsible for detecting fraud only when such detection could occur through the application of generally accepted auditing standards (GAAS) [Holdren, 1969; Carmichael, 1975; Kapnick, 1976]. Yet, GAAS was seen to guide the conduct of "ordinary" audit examinations—those in which fraud was not thought to occur. Indeed, audits were assumed to be performed in a corporate environment of honesty and integrity [Solomon and Muller, 1977] and auditors were not required to presume that fraud had occurred while conducting an audit [Kapnick, 1976]. As a consequence, the application of GAAS could not be "relied upon to assure the discovery of either defalcations and similar irregularities or deliberate management misrepresentations" [Carmichael, 1975, p. 79].

[5]Through such arguments, auditors were also aligning their work with notions of efficiency.

From this perspective, if auditors properly applied GAAS in an engagement but failed to detect fraud, then no audit failure had occurred even though the financial statements might contain errors. The audit profession thus limited its definition of an audit failure to include only those cases in which an auditor failed to apply GAAS. In doing so, it maintained that auditor performance and their roles and responsibilities were to be assessed only by reference to the rules and guidelines established by the profession. Auditors were to be evaluated on their own terms rather than by reference to the roles and responsibilities that nonauditors might believe should guide the conduct of an audit.

In defining an audit failure as a failure to follow GAAS, the profession was promoting and claiming its right to establish definitions of "fairly present" and to perform its work as it saw fit [Abbott, 1988]. Even as it continued to call upon broader cultural values such as the credibility of financial statements to justify and legitimate the usefulness of an audit, the profession also attempted to control and define the terms used to assess whether these values had been achieved. In this way, and through these definitions, the audit profession was attempting to construct and define the "proper" roles and responsibilities of auditors. Furthermore, with its limited definition of an audit failure, the profession was apparently attempting to equate the performance of an audit in accordance with GAAS as sufficient evidence that the cultural value of credible financial statements had been achieved [Abbott, 1988]. If audited, financial statements were to be seen as credible. The profession was attempting to preclude public discussions of the meanings and significances to be assigned to the audit and, instead, sought to define those terms seen to provide the audit process with value in ways desired by the profession, and thereby to control the significance of work performed within its jurisdiction.

QUESTIONING THE DEFINITIONS PROVIDED BY AUDITORS—1970s

Although the profession forwarded its desired definition of an audit failure and thereby of a "quality" audit, the revelation of scandals such as Westec, Yale Express, and Bar-Chris [Why Accountants, *Business Week*, 1971] as well as National Student Marketing [*Wall Street Journal*, October 29, 1974], Beverly Hills Bancorp [*Wall Street Journal*, August 14, 1974], and Equity Funding [*Wall Street Journal*, January 8, 1975; January 10, 1975; December 18, 1975] raised questions about the propriety of the auditing profession's definitions, including questions about its roles and responsibilities in detecting fraud. Some commentators suggested that if audits could fail to detect a fraud of the magnitude of Equity Funding, then as currently conducted they might have little value [*Wall Street Journal*, July 12, 1974; Hershman, 1974]. The Equity Funding scandal was seen to place intense pressure upon auditors to accept a duty to detect fraud [*Wall Street Journal*, January 8, 1975].

Members of the SEC also criticized the profession's position on fraud. Some commissioners considered auditors in a strategic position to "nip fraud before it blossoms" and criticized them for failing to heed "red flags" that were indicative of potential fraud [*Wall Street Journal*, July 12, 1974]. In referring to several major cases of substantial management fraud, one SEC commissioner commented:

> In most of these cases, the fraud was one which was designed to present a misleading picture of results through transactions with related parties or through outright fictitious transactions...If the accounting profession adopts the view that auditors should never be responsible for detecting management fraud, there is little likelihood that increased imposition of the truly onerous and unfair burdens on the accounting profession can be prevented. Standards can best be promulgated by the profession and can serve to allay fears that auditors will become insurers against all forms of management fraud, however carefully concealed [News Report, *Journal of Accountancy*, 1973a, pp. 14,16].

He urged the profession to accept responsibility for fraud detection [*New York Times*, October 17, 1973] as did the Commission more generally: "We believe that in examinations for corporations whose securities are held by the public, accountants can be expected to detect gross overstatements of assets and profits, whether resulting from fraud or otherwise" [quoted in Hershman, 1974, p. 53].

In addition to concerns about auditor responsibilities to detect material errors, auditors were criticized for a perceived failure to maintain their independence from their corporate clients [It's Time to Call, *Fortune*, 1970; Why Accountants, *Business Week*, 1971]. These questions were particularly troubling as they suggested that auditors had failed to meet their own definitions of a "quality" audit. Did auditors serve their corporate clients or act in the public interest by protecting investors and creditors [The Big Bath, *Newsweek*, 1970; Why

Accountants, *Business Week*, 1971; *New York Times*, November 5, 1973]? Were auditors "too friendly" with management and should they continued to be hired as employees by their former clients [*New York Times*, November 18, 1972]? Had heightened competition within the profession resulted in an increasing unwillingness by auditors to insist on "compliance" with financial accounting standards and to "pursue incompetence" [Letter to the Editor, *New York Times*, December 7, 1975]? Was a "more muscular audit" needed to alleviate pressures on auditors to provide creative accounting answers for clients who otherwise threatened to change auditors [*New York Times*, April 14, 1974]?[6]

Although accounting writers indicated an awareness of criticisms that auditors were not adequately independent of corporate clients, that accounting results disclosed too little, and that financial statements were too complex [e.g., Seidler, 1973], the general response of the profession to these criticisms can be summarized in a single phrase: "You just don't understand." Even as auditors continued to argue that audits enhanced the credibility of financial information, they also claimed that audits were not designed to detect fraud. While auditors insisted they could enhance the credibility of financial reporting without actively searching for fraud, the public appeared to disagree with this position and apparently expected that significant or material fraud would be detected by an audit.[7] In contrast to the definition of an audit failure forwarded by the profession, the public defined such failures as including those audits

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[6] Apparently, the Securities Acts were not as effective in allowing auditors to escape the "grip" of management as was originally hoped [McCraw, 1984], nor were the rules on independence sufficient to achieve this end despite an awareness by the profession of the need for public confidence in the "unbiased and selfless character of the public accountant's role" [Miranti, 1990, pp. 176-177].

[7] For example, a 1974 Arthur Andersen & Co. survey "indicated that 66% of the investing public believe[d] that the most important function of the public accounting firm's audit of a corporation is to detect fraud" [cited in AICPA, 1978, p. 31]. Further, Baron et al. [1977] reported survey results in which nonauditors indicated higher levels of auditor responsibility for the detection of deliberate material falsifications than did auditors. With the exception of auditors, the survey respondents also indicated a preference for extending auditor responsibilities with respect to the detection of deliberate material falsifications of financial statements.

which did not detect material fraud or errors. This difference in definition called into question the propriety of the practices both followed and defined by auditors in conducting audits. The controversy surrounding Equity Funding and other corporate failures as well as questions about the independence of auditors suggested that the profession had not succeeded in equating the performance of an audit in accordance with GAAS as sufficient evidence that credible financial reporting had been produced. These corporate failures highlighted differences between the ways in which the auditing profession linked the audit to credible financial reporting and how the public interpreted this linkage.

The profession interpreted these criticisms as indicative of a failure by the public to understand the roles and responsibilities which it had defined. The public was described as misinformed about the services customarily performed by CPAs [Solomon et al., 1976, p. 68]. These differences between public interpretations and auditor interpretations of how an audit was to intersect with the production of credible financial statements were construed by auditors as indicative of a need to educate the public. A properly educated public would accept that audits could enhance the credibility of financial statements without serving as guarantees of the accuracy of financial statements [Hershman, 1974]. In emphasizing the necessity for educating the public, the profession attempted to avoid reassessing its own definitions of its roles and responsibilities. Instead, confronted with these differences and interpretations, the audit profession renewed its efforts to dominate the signficances to be assigned to its roles and responsibilities and to persuade the public to accept the value of an audit as defined by auditors. In particular, the profession sought to manage impressions, emphasized better communication by auditors, called upon other cultural values to justify its position, and outlined expertise and its limits.

Managing Impressions. Through various means, the AICPA attempted to manage public impressions about the roles and responsibilities of the audit profession. In 1973, the AICPA Board of Directors announced the formation of a special committee "to study whether the auditing standards, which are currently considered appropriate and sufficient in the examination of financial statements [by the AICPA], should be changed in the light of Equity Funding and to report its conclusions to the Board of Directors and the auditing standards executive committee" [News Report, *Journal of Accountancy*, 1973b, p. 14]. The Institute justified forming the committee by indicating that "the Institute shares the general public concern about the

Equity Funding disaster, which caused enormous losses to investors and creditors apparently by reason of massive and collusive fraud" [News Report, *Journal of Accountancy*, 1973b, p. 14]. Although some individuals claimed that no lessons could be learned from such a poorly conducted audit engagement, others suggested that the fraud was possible because Equity Funding employees had exploited blind spots and crevices in existing audit practices [*Wall Street Journal*, January 8, 1975; Tipgos, 1977].

This AICPA special committee later concluded that the Equity Funding fraud could have been detected using existing auditing standards and that the professional position with respect to its responsibility to detect fraud was sound [*Wall Street Journal*, June 5, 1975; Olsen, 1982]. For the committee, the Equity Funding scandal was not interpreted as evidence of the profession's failure to perform appropriate tasks but rather as a failure by individual auditors to follow established rules and guidelines. Even so, the committee urged that the standards relating to fraud detection be restated in more positive terms to avoid public misunderstandings of the audit and to reemphasize that audits might detect fraud but were not specifically designed to do so [Olsen, 1982]. The committee in this way reasserted the position of the profession with respect to fraud detection and maintained that the audit purposes as previously articulated were sound. The problem confronting the profession was thus seen as one of educating the public about the proper role of the auditor rather than a reconsideration of this role. Audits were not designed to detect fraud, and the public was to accept the profession's definitions of its roles and responsibilities.

This emphasis upon interpreting public criticisms as the public's failure to understand the auditor's role can also be seen in the 1974 formation of the Cohen Commission on auditor's responsibilities.[8] This commission was charged with "determin[ing] whether a gap exists between what the public expects of auditors and what auditors can reasonably be expected to accomplish [News Report, *Journal of Accountancy*, 1974, p. 14]. The wording of this announcement suggested the results the AICPA anticipated the Commission would find: the public's expectations of auditors were unreasonable and auditors had appropriately defined their tasks. As part of its efforts at impression management, the AICPA later pointed to the formation of the Cohen

[8]The Commission was to explore mechanisms for developing auditing standards, possible alterations to the standard audit report, and whether auditors should monitor all financial information released to the public.

Commission as evidence that it was taking the steps necessary to police itself: "We're going to show that accountants are concerned about the consumer" [*New York Times*, May 9, 1976]. Apparently, the formation of the Commission rather than any changes resulting from its possible recommendations was to be seen as sufficient evidence of auditor concerns about discrepancies between public and auditor interpretations of how to define auditor tasks and responsibilities.

Emphasizing Better Communication. Again, criticisms of auditors were interpreted as the public's failure to understand properly the role of the auditor. However, this failure was now explicitly attributed to faulty communications between the auditor and the public. At times, this faulty communication was blamed upon the media for misleading the public:

> and if the public has cast the accountant in the role of the nemesis of all those who would embezzle funds, falsify financial statements or commit other corporate crimes, it is not altogether at fault. Some of the recent publicity in connection with lawsuits involving prominent accounting firms appears to lend considerable credence to the idea that the auditor is, in the final analysis, the conscience of business, big and small. In reality, this is a popular misconception [Silverman, 1971, p. 80].

At other times, faulty communication was attributed to the existing audit opinion. In 1969, Roth [p. 61] argued that

> A better understanding of the independent auditor's role by the users of our reports and by the public generally might go far toward reducing the number of cases taken to court and resultant unfortunate legal decisions. One means of attaining better understanding could possibly be a clearer explanation of the scope and purpose of our audit in our short-form report.

Rosenfield and Lorenson [1974] also blamed the ambiguous audit report for the turmoil over auditor responsibilities. In particular, they faulted the statement made within this standard report that claimed financial statements were presented fairly in accordance with generally accepted accounting principles. They recognized that this statement could be subject to a number of different interpretations, each of which implied differing responsibilities for auditors.

The failure of the public to understand was in part a consequence of poor communication by auditors. As such, the solution to then current controversies surrounding the audit profession was to consider "improving" the audit report so as to describe better the profession's conception of an audit's purpose. However, this purpose was still to be defined by the profession. Apparently, "improved communication" was to be a monologue in which the public would be told by the profession what it could "reasonably" expect from an audit. In calling for altered audit reports, there was a presumption that the existing practices, roles, and responsibilities of auditors were appropriate. The public was to accept that the audit profession knew best how to enhance the credibility of financial information.

Calling Upon Other Cultural Values. Other authors attempted to justify more directly the position of the profession with respect to the discovery of fraud. They attempted to convince the public (or perhaps only Congress and the SEC) that its interpretations of the role of an audit were unreasonable and inappropriate. Some pointed to the confusion regarding the definition of fraud and noted that many business failures arose from other factors such as bad management or adverse economic conditions [Catlett, 1975]. They also argued that requiring auditors to accept responsibility for fraud detection would interfere with American cultural values of "free" enterprise and "opportunity for all" [Catlett, 1975; Cooney, 1995]. By imposing such requirements on auditors, they would be reluctant to accept more risky companies as clients. As a result, these companies (often start-ups) would be unable to obtain audit services and would thereby be effectively denied access to capital markets. Following this chain of reasoning, free enterprise, and consequently competition within industries, would be hampered if auditors were required to accept fraud detection as one of their responsibilities. Stated in other words, the "traditional" responsibilities of auditors as currently defined served to promote greater economic opportunities for all.[9]

It was also argued that requiring auditors to accept this

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[9]Interestingly, some individuals attempted to employ the weight of "tradition" as a reason to maintain the status quo. They claimed that fraud detection conflicted with the "traditional" audit approach and was, in general, too costly an undertaking [e.g., *New York Times*, April 6, 1975]. However, these arguments represented an effort to construct such a tradition. The Cohen Commission later traced the steady erosion of fraud detection as an audit objective [AICPA, 1978, pp. 33-35]. See Hobsbawn and Ranger [1984] on the construction of traditions.

responsibility would sacrifice another cultural value—efficiency [Abbott, 1988]. Relative to the large number of audits conducted each year, the incidence of undetected fraud (an audit failure as defined by the public) was claimed to be small (a claim perhaps impossible to either refute or substantiate). Requiring auditors to search actively for fraud would result in the performance of additional audit procedures. But if one assumed that undetected fraud was a relatively infrequent event, then obviously such additional efforts would not be cost-effective [Hershman, 1974], but rather a waste of auditor time and client money.[10]

Outlining Expertise and Its Limits. Again, auditors maintained that the public failed to understand the particular expertise of auditors. Some expressed the opinion that an adequate answer to the question of what "good" is an audit that could not provide assurance that material fraud was detected "is exceedingly involved and probably beyond the grasp of the average user of the auditor's work" [Carmichael, 1979], the "non-expert." Others questioned the ability of such non-experts to understand the "esoteric, highly specialized professional standards and responsibilities" of the auditor [Solomon et al., 1976]. In effect, because the public was not expert in auditing, the nature and extent of the complex tasks underpinning the audit report were best left to those specifically trained in undertaking these tasks. In making these arguments, Solomon et al. [1976] criticized the actions of the trial judge in the Continental Vending case who had instructed the jury that "proof of compliance with GAAP [generally accepted accounting principles] is evidence which may be very persuasive but not necessarily conclusive that [the auditor] acted in good faith, and that the facts as certified were not materially false or misleading." The judge's instructions were to be seen as inappropriate because the professional expertise and judgment of the audit profession was being effectively supplanted by that of a less informed and knowledgeable jury. Instead, for these authors, the jury should have been instructed that compliance with generally accepted accounting principles would be sufficient to acquit the auditors. In forwarding these arguments, the authors suggested that the audit should be considered an end in itself and that the means to this end were best left to the experts, the audit profession. In deciding whether an audit had resulted in the production of reliable financial reports, one need look no further than assessing whether the statements were prepared in accordance with the established accounting rules and auditing standards.

[10]This argument echoes that made by Montgomery [1940] to explain why fraud detection was not an audit purpose.

Even as some maintained that the expertise of auditors lay beyond the understanding of the general public, others argued that this expertise also had its limits. Now, auditors were argued to possess no special powers in detecting fraud. They were not favored with hindsight and conducted audits under a presumption of honest management [*New York Times*, April 6, 1975]. As such, the audit profession could not and should not undertake responsibilities it could not successfully fulfill [Catlett, 1975].[11] Such justifications for the status quo presumed a certain fixity in the nature of an audit engagement and a self-assurance as regards its continuing relevance in the face of efforts to exclude nonauditors from any role in defining its nature and purpose. These justifications also suggested an extraordinary confidence in the continuing importance of the audit profession and its self-defined tasks.

In issuing revised auditing standards on fraud and illegal acts in the late 1970s, the profession attempted to maintain the status quo. The fraud standard repeated previous professional statements about the limitations of the existing audit process, limitations that might allow errors to remain undetected. As such, it was seen to do little more than to reiterate "traditional" audit doctrine and to emphasize that frauds do occur [*Wall Street Journal*, May 6, 1976] and might remain undetected. Similarly, the proposal on illegal acts explicitly recognized the expertise limitations of auditors and indicated that auditors could not be expected to provide legal opinions. Again, this new requirement was seen to have little effect upon existing auditor responsibilities [*Wall Street Journal*, January 31, 1977].

The articles appearing in the accounting practitioner journals and elsewhere during this period seemed to emphasize the necessity for making the public understand the auditor's roles and responsibilities as interpreted by auditors. This understanding was to be imposed upon the public by the profession. Although auditors claimed to act in the public interest, they also maintained that as "experts" they were best qualified to decide their responsibilities. They argued that the profession was best situated to decide what constituted reasonable public expectations with

[11]This lack of expertise/professional competence argument was also used to justify resistance to placing upon auditors a responsibility for the detection of illegal payments [*New York Times*, September 28, 1976]. Many illegal acts were seen as far removed from entity's financial affairs (the area of audit expertise). As such, it was unlikely that an auditor could detect them during the audit engagement (e.g., violations of OSHA or EPA regulations) [Solomon and Miller, 1979].

regards to audit performance and auditor roles and responsibilities. Auditors were to define these tasks both for themselves and the public; they were to control the activities within their professional jurisdiction and to decide whether the credibility of financial statements was being enhanced by their activities.

CHANGING THE TERMS OF DEBATE

In 1976, a highly critical Senate staff study was released about the accounting profession [U.S. Senate, 1976]. This study claimed that the professional interests of auditors were too closely intertwined with those of large corporate clients, attacked auditor claims of independence and questioned the reliability of private audits [*New York Times*, January 23, 1977]. In a cover letter, Senator Metcalf stated that the Big Eight accounting firms had shown "an alarming lack of independence and lack of dedication to public protection" [*New York Times*, January 17, 1977]. The study suggested that governmental regulation of auditors might be necessary, including the establishment of federal auditing standards [*Wall Street Journal*, January 17, 1977]. It also questioned the appropriateness of the existing process for establishing accounting standards [U.S. Senate, 1976]. Initially, the AICPA expressed dismay at the Senate staff's

> unwarranted conclusions. This effort [of the AICPA over 35 years] combined with actions of SEC results in achieving the highest quality of financial reporting and disclosure of any country in the world [*Wall Street Journal*, January 17, 1977].

Partners from Big Eight firms were reported as describing the staff study as both wrong and superficial [*New York Times*, January 17, 1977]. Despite these assertions, several auditors who later testified during the Congressional hearings about the study urged Congress to allow the auditing profession time to reform itself.

With the publication of this report and the convening of subsequent Congressional hearings, attention appeared to shift away from questions about the appropriate roles and responsibilities of auditors and towards an emphasis upon finding specific practices that could serve as symbols suggestive of the appearance of auditor independence. The threat of an increased federal role in the operations of the auditing profession appears to have been a critical element in this shift. The "new" practices installed during this period included the formation of audit committees, disclosures of disagreements between auditors and corporate clients, and the implementation of mechanisms to discipline and control the actions of auditors, such as peer review. In emphasizing the development and implementation of these practices, questions that had earlier been raised about the proper roles and responsibilities of auditors faded into the background. This shift was quite significant in that it allowed the auditing profession to continue forwarding its preferred meanings for an audit and its definitions of the appropriate roles and responsibilities for auditors. With this shift, attention was redirected from the interpretations to be accorded an audit to focus instead upon the sorts of services an audit firm could be permitted to provide and still claim its independence from clients and the types of disciplinary techniques needed to convince nonauditors that professional self-regulation was possible and workable.[12]

This shift from a consideration of roles and responsibilities to finding and installing specific practices of self-regulation occurred in spite of the publication of the tentative and final conclusions of the Cohen Commission. In its tentative conclusions, this Commission suggested that the expectations gap often described by auditors as unreasonable was apparently ". . . caused by the failure of auditors to fully assume responsibilities they are capable of assuming, rather than by unreasonable user expectations" [Seidler, 1977, p. 20]. The Cohen Commission recommended that auditors be required to provide a broader range of information about corporate clients and to expose publicly the wrongdoing of clients in certain circumstances. It further recommended that the auditors clarify their responsibility for fraud detection. In making this recommendation, the Commission commented that the users of financial statements "should have the right to assume that audited financial information is not unreliable because of fraud and that management maintains appropriate controls to safeguard assets" [AICPA, 1977, p. 36]. In other words, credible financial reporting could not be produced if auditors failed to detect material fraud.

These recommendations suggested that public interpretations of the significance of the audit and auditors' responsibilities of should supersede some definitions forwarded by the profession. While the profession was to decide how these different tasks would be implemented, the Commission explicitly accepted a role for the "public" in defining the responsibilities of auditors. In this way, its recommendations might have been seen to threaten the dominant role of

[12] See Fogarty [1996] on peer review.

the profession in defining its own roles and responsibilities. Unsurprisingly, its recommendations tended to be ignored by the AICPA.[13]

INTEREST RENEWED

As the 1980s began, Congressional interest in accounting and auditing matters subsided. In 1981, the New York Times commented:

> Pressure for Federal regulation has waned. The Securities and Exchange Commission has shredded its letters warning of the importance of auditor independence from the companies they audit. And, perhaps most surprising, certified public accountants now occupy powerful positions in Washington [*New York Times*, October 7, 1981].

In this same article, an AICPA representative was quoted:

> For the first time in years, the accounting profession is experiencing real power in Washington not just outside influence.

Even as regulatory interest in accounting waned, articles continued to appear in the press (although with less frequency than earlier) that were critical of auditing and accounting. The media continued to report on the ways in which "slick" accounting ploys were used to improve the reported income of companies [*Wall Street Journal*, June 20, 1980], on the rise of accounting "scams" accepted by auditors without qualification [*Wall Street Journal*, July 9, 1982], about SEC charges that financial statement "fudging" was a growing practice [*Wall Street Journal*, June 2, 1983; "The SEC Turns Up the Heat," *Business Week*, 1984] and on the increasing number of corporations that fired auditors who had issued

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[13]Indeed, the AICPA was accused of responding superficially to these recommendations by studying the report intensively in small committees while failing to heed its advice [Seidler, 1979]. For example, the AICPA announced the formation of a committee to study the tentative conclusions of the Cohen Commission in 1977. This announcement also suggested the importance of the Commission for public relations purposes: "This is the type of independent study that would benefit any profession which is accountable to the public" [News Report, *Journal of Accountancy*, 1977, pp. 16, 18].

qualified audit opinions [*Wall Street Journal*, May 12, 1983].

As the prohibitions on advertising and client solicitation were either dropped or substantially reduced, competition within the auditing industry (often taking the form of price competition) increased dramatically and auditing firms entered into the "alien world of marketing" [*Wall Street Journal*, March 18, 1981]. Accounting firms were now characterized as ever more aggressively "courting competitors' clients, promising lower audit fees" [*New York Times*, October 3, 1984] and squeezing profit margins on the traditional auditing business of the large accounting firms [*New York Times*, December 30, 1984]. In this environment, concerns were raised about "whether growing competitive pressures [might] be encouraging auditors to bend the rules in favor of clients, such as keeping a questionable loan on the books to keep up the bank's profits on paper" [*New York Times*, March, 10, 1985]. Questions were also raised as to whether audits had become "loss leaders used merely to win more profitable management and tax-consulting contracts with the client" [*New York Times*, February 18, 1985]. These questions suggested that auditors were failing to carry out the roles and responsibilities which they had defined for themselves. They implied or stated outright that auditors and audits were not enhancing the credibility of financial statements in at least some instances.

Such questions arose amidst a number of significant "audit failures" occurring relatively soon after an entity had received an unqualified audit opinion ["Auditing the Auditors," *Business Week*, 1983]. In 1982, Penn Square Bank collapsed three and one-half months after receiving an unqualified audit opinion [*Wall Street Journal*, July 29, 1982]. Although the auditors had warned Penn Square directors that the bank's financial problems were growing, they issued an unqualified audit opinion because of perceived risks to depositor confidence [*Wall Street Journal*, August 17, 1982]. Similarly, three weeks before the FDIC declared United American Bank insolvent, its audit firm issued an unqualified audit opinion on the bank's financial statements even though many federal investigators had been present during the audit [*Wall Street Journal*, March 4, 1983]. In 1984, the *New York Times* listed several instances of alleged audit failures including Litton Industries, Security America Corporation, Drysdale Government Securities Corporation, Saxon Industries, Flight Transportation, Alpex Computer, United American Bank, Penn Square Bank, and Datapoint [*New York Times*, May 13, 1984]. Later, the *New York Times* [November 23, 1984] reported several lawsuits pending against a single international accounting firm arising from audit work at DeLorean Motor Company, Nucorp Energy, Seafirst National Bank, Frigitemp, the Reserve Insurance Co., and the Financial Corporation of America. Between 1980 and early 1985, the largest accounting firms paid more than $175 million in settlements and judgments over disputed audits [McComas, 1986].

Despite earlier efforts to convince the public that the profession had no responsibility to detect fraud, the significant number of instances designated as "audit failures" again raised questions regarding the significances that could be accorded to an unqualified or "clean" audit opinion. For example, the *New York Times* [May 13, 1984] commented that auditors are thought of as

> the watchdogs who will detect fraud or emerging financial problems before those problems sink a bank or make a corporation's stock price plunge.
>
> But such faith has been eroded lately through a series of incidents in which some of the most elite accounting firms have blessed a financial statements on the eve of disaster.

Were auditors fulfilling this responsibility? Did the audit enhance the credibility of financial reports?

In 1985, Congressional attention again focused upon the auditing profession and hearings were held about the role of auditors. Before these hearings began, Rep. Dingell, the Committee chair, indicated his concerns about "whether accounting is giving us a fair and accurate and truthful picture of what is going on in the industry" [*New York Times*, February 18, 1985]. His committee intended to raise questions regarding whether competitive pressures and MAS services were eroding the independence of auditors [*New York Times*, February 18, 1985] and why auditors had not provided advance warning of the deteriorating financial condition of banks and other companies [*Wall Street Journal*, February 12, 1985; February 19, 1985].

In opening the hearings, Dingell referred to a U.S. Supreme Court description of the auditor's role:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client....This public watchdog function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust [quoted in Miller, 1986, pp. 28-29].

The media also reported charges by the Dingell committee that the

> existing regulatory framework had not been effective in providing a warning system that might have prevented a series of financial disasters in the last few years—including the run on Continental Illinois National Bank, and the collapse of Penn Square Bank and Drysdale Government Securities. In each case, auditors gave the company's financial statements a clean opinion shortly before disaster struck [*New York Times*, March 7, 1985].[14]

Given these concerns, the Dingell committee investigated the role of accounting firms in "blessing" those accounting practices that were perceived to mask the financial condition of several savings and loan entities that later failed. Comments in the press indicated that the committee believed self-regulation was flawed: ". . . the same people write the (financial accounting) rules, interpret the rules . . . [sic] and enforce the rules" [*Wall Street Journal*, March 7, 1985]. Dingell commented:

> The present self-regulatory system permits the accounting firms to control the setting of audit standards, to apply those standards to individual clients, and to sit in judgment of themselves when an audit failure occurs. All of this is done in private [quoted in Miller, 1986, p. 32].

The many alleged audit failures raised renewed concerns about the independence and objectivity of auditors in the high-pressure competitive environment in which accounting firms also offered consulting services [Dingell, 1985; *Wall Street Journal*, September 20, 1985]. During the hearings, Dingell highlighted these concerns by referring to a newspaper advertisement that ended by saying "In fact, there's only one thing wrong with calling ourselves Deloitte Haskins & Sells & You. The You really should come first." He commented: "That doesn't sound too independent to me" [*New York Times*, March 10, 1985]. The terms employed in the previous paragraphs to describe the perceived problems with auditing are quite telling—a public watchdog function, an early warning system, "inappropriate" clean bills of health, "blessing" of misleading financial accounting practices, and concerns about the

[14]Also see *New York Times* [March 10, 1985].

"independence" of auditors. Admittedly, some of these terms might be seen as high-flown rhetoric by a Congressional committee desiring the public attention it could receive by focusing upon the perceived failures of auditors. However, by asking whether the public watchdog function of auditors was impaired, the committee suggested that auditors should serve this function. In suggesting that auditors had failed to provide advance warning of imminent corporate failures, the Committee implied that auditors had this responsibility. Further, in saying that auditors had "blessed" misleading accounting practices, the Committee claimed that auditors had failed to carry out the roles and responsibilities which the profession had defined for itself. The committee's allegations were thus doubly damning—not only had auditors failed to define their tasks properly but they had also failed to perform the work which they themselves had defined as appropriate.

The Dingell hearings challenged the definitions of roles and responsibilities advanced by the profession. These hearings suggested that the issuance of an audit report implied broader responsibilities than those previously accepted and advocated by auditors. During the 1970s, auditors had maintained that audits were not specifically designed to detect fraud. Now, they were again criticized for failing to detect fraud and also for failing to provide an "early warning" of possible corporate failures. The media, in its coverage of the Dingell committee hearings and elsewhere, appeared to define an audit failure as the issuance of a "clean" audit report shortly followed by the declaration of corporate bankruptcy or the incidence of financial problems [*Wall Street Journal*, February 21, 1985; March 7, 1985]. This definition contained no reference to GAAS and implied that an audit failure could occur even when an auditor had followed such practices, a definition that conflicted with that provided by the auditors.

Auditor Response. The auditors responded by attempting to defend their own definitions of the roles and purposes of an audit and to deny that the existing system was "broken." In testimony before the Dingell Committee, Philip Chenok, AICPA president, indicated that the incidence of audit failures was quite small relative to the large number of audits performed, claiming that of 50,000 audits performed since 1979 only 123 might be called "audit failures" [*Wall Street Journal*, February 19, 1985]. In a later editorial, Chenok again stressed the relative infrequency of audit failures noting that "audit failures can and do occur but they are rare in relation to the tens of thousands of audits conducted each year. They result from human error by individual auditors. They do not reflect the overall quality of work in the profession" [*New York Times*, March 17, 1985]. The small number of acknowledged audit failures was used to suggest that the current system was operating properly.

The audit profession and others again argued that nonauditors had failed to understand the "proper" role of the auditor and the signficances that could be appropriately assigned to audit opinions. For example, Chenok [1986] noted that the Dingell hearings were concerned with whether auditors had effectively discharged their duties. He maintained that in order to answer this question one must understand the function of the independent audit—it was to report on the fairness with which financial statements presented corporate financial position [Chenok, 1986]. The audit profession was to be judged on its own terms.

As in the 1970s, auditors maintained that criticisms of the profession resulted from the public's failure to understand the "appropriate" role of the auditor and to accept the definition of this role as forwarded by auditors. From this perspective, an unqualified audit opinion was to be seen as providing reasonable assurance that financial statements conformed with generally accepted accounting principles rather than as providing evidence of a "clean bill of health." As such, an unqualified opinion might be appropriate for a company on the brink of financial collapse as long as the financial statements "reflect[ed] a fair and accurate picture of the company's financial condition" [*New York Times*, March 10, 1985].[15] Furthermore, audits were not foolproof as the audit process relied upon a small sample of company transactions, many accounting matters were open to judgment [*New York Times*, March 10, 1985; Chenok, 1986] and fraud was difficult to detect [Chenok, 1986].

Perhaps the following quote best summarizes the audit profession's position with regard to the controversy surrounding its work:

> A number of the questions raised in your proceedings [the Dingell Committee] and in our own studies of these matters are provoked by even more fundamental questions concerning auditor performance. These questions involve not how well the

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[15]However, if an entity was seen to be on the brink of collapse, the going concern assumption would be invalid and the use of historical cost accounting inappropriate according to generally accepted accounting principles. One wonders how many financial statements of companies that failed shortly after receiving an unqualified audit opinion were prepared using a basis of accounting other than historical cost.

auditor has performed, but whether the auditor must undertake additional responsibilities to satisfy society's needs. Repeatedly it has been asserted that the public is seeking more from auditors in the area of protection from fraud and early warnings of business failure. In these respects, it would seem that there exists a gap between public expectations of the auditor's role and that which the auditor is, in fact, today performing. It is our belief that skepticism about the work of independent auditors has more to do with this mismatch. . . than it does with actual performance failures [cited in Miller, 1986, p. 34].

Again, the profession attempted to reframe concerns about its work as evidence of rising public expectations rather than as a controversy over the meanings to be assigned to audit reports and audit work and who would decide such meanings. Although concerns about the responsibility of auditors to detect fraud had arisen previously, the profession had not substantially altered its conception of its responsibilities or accepted an explicit responsibility to detect fraud or warn of imminent corporate collapses. It was still attempting to dominate definitions of its roles and responsibilities and to resist those forwarded by the Dingell committee and the press. Again, it formed a committee amidst the controversy. This committee was to "look at the current responsibilities of management, the auditors within and outside the company to detect fraud" [*Wall Street Journal*, February 12, 1985] and to develop methods to prevent and detect fraud among public and closely held companies [*Wall Street Journal*, February 19, 1985].[16] The framing of the issue to be investigated by this panel suggested the answer desired by the AICPA. In particular, note the ordering of the individuals whose responsibilities were to be investigated: managers followed by internal auditors followed by external auditors. This ordering might be interpreted to reflect the profession's interest in maintaining that the detection of fraud was primarily management's responsibility.

Congressional Intervention? Despite the arguments of the audit profession and SEC and the tentative actions taken by the audit profession, several Congresspersons introduced legislation to require

[16]In announcing the formation of the panel, the AICPA denied that its formation was linked to the Dingell hearings that were due to begin on February 20, 1985: "We have been considering suggesting formation of this panel since last September, and we aren't doing this in reaction to the hearings" [Chenok in Wall Street Journal, February 12, 1985].

auditors to report to Government authorities suspicions of fraud or other illegalities noted during an audit [*New York Times*, May 23, 1986]. Rep. Wyden, a bill sponsor, indicated that "We've got to have an early warning system out there" [*New York Times*, May 23, 1986].[17] Despite criticisms, the audit profession was still seen as a means to enhance the credibility of financial reporting. The bill did not propose replacing auditors with other experts. Instead, the responsibilities of the profession would be altered and expanded by this legislative action. The bill was of course, opposed by accounting firms as well as by the SEC and certain trade groups [*Wall Street Journal*, August 19, 1986].

In justifying this opposition, certain members of the profession expressed concerns that by requiring auditors to "blow the whistle" the relationship between the auditor and the client would be fundamentally altered [e.g., *Wall Street Journal*, June 20, 1986], "put[ting] us into an adversarial police-like role with corporations we currently service, and no one would benefit" [*Wall Street Journal*, May 23, 1986]. Auditors would become nothing more than "state-regulated examiners" when auditing "should be a private-sector activity, not an extension of the government's role" [*Wall Street Journal*, May 23, 1986]. Changing the role of independent auditors "to a police role" would detract from the primary responsibility of auditors—that of providing opinions as to whether corporate financial statements accurately reflect the "true" financial condition of a company [*New York Times*, May 23, 1986].

This proposed role for auditors would be "unworkable in relation to the auditor's principal objective of assessing the fair presentation of financial statements in accordance with generally accepted accounting principles . . ." [Miller, 1986]. The bill was seen as "unworkable" in part because it conflicted with the auditing profession's definition of its own roles and responsibilities. From its perspective, auditors were to assess whether financial statements fairly presented financial condition and performance, a task that did not require them to search actively for fraud even if it might result in material misstatements of financial condition and performance. These comments suggest the reluctance of auditors to alter their conception of their roles and responsibilities and a desire to dominate the definitions of tasks and responsibilities within their jurisdiction.

[17] Wyden later introduced a watered down version of the bill to require auditors to inform management about significant fraud and then to notify the SEC only if management failed to act properly upon such information within three months [*Wall Street Journal*, August 19, 1986].

Other prominent members of the auditing profession began to advocate altering professional responsibilities to include a responsibility for fraud detection. Change was seen as necessary in light of public expectations that auditors and the financial reporting system would warn the public of impending failures [Bertholdt, 1986]. Although the auditing profession was not described as failing to meet its public responsibilities, some believed it could no longer ignore the concerns raised by Congress, courts and the public. The expectations of the public were described as changed and so the roles and responsibilities of auditors and financial reporting should also ". . . be amended to provide the 'predictive' value the public now demands" [Connor, 1986, p. 77]. Perhaps, in these changed circumstances, auditors should accept responsibility to search for conditions that might lead to materially misstated financial statements and to reduce the risk that fraud would remain undetected [also see editorial by Connor in *Wall Street Journal*, December 3, 1985].

A limited role for the public in defining auditor's roles and responsibilities was also implied by the Treadway Commission report which recommended amending the auditor's opinion to indicate that auditors could provide reasonable but not absolute assurance that financial statements were free of fraud [*New York Times*, July 13, 1987].[18] This role was further recognized with the issuance of several new auditing standards in 1988 that were intended to improve auditor performance and communications, to address the concerns raised by the Treadway Commission report, and to narrow the expectations gap. Among other requirements, these standards enjoined auditors to be alert for illegal activities during the conduct of an audit, to design audit work to provide reasonable assurance of detecting material irregularities and errors, and to inform the board of directors of any such findings.[19] These

[18] This report also recommended that all public companies be required to have audit committees and that auditors be evaluated by their peers. However, the report contained little evidence that audit committees, peer reviews, or an altered audit opinion would educe the incidence of fraudulent financial reporting. Indeed, pTL which was embroiled in financial scandal had an audit committee. However, the committee was composed of individuals with little experience, and they served primarily to rubber stamp the fraudulent activity of pTL officers such as Jim Bakker [Tidwell, 1993].

[19] Rep. Wyden criticized the new standards on the detection of fraud as he believed auditors needed to report suspicions of fraud to regulators]*Wall Street Journal*, February 10, 1988].

standards implied that, in designing audits, auditors could no longer presume that management was honest and expressed more affirmatively the responsibilities of auditors relative to fraud [Carmichael, 1988]. The audit report was also revised in an effort to articulate more clearly the responsibilities of auditors to detect errors and irregularities. In particular, the following sentence was added to the report: "Those standards [GAAS] require that we plan and perform the audit to obtain **reasonable** assurance about whether the financial statements are free of **material** misstatements" [Roussey, et al., 1988, p. 45, emphasis added]. The new audit standards also required auditors to evaluate whether there was substantial doubt about a company's ability to continue as a "going concern" and to disclose such doubts.[20]

Reactions to these standards by auditors included criticisms of the lack of clarity in detailing the extent of the auditor's responsibility to detect fraud [Neebes & Roost, 1987]. Others continued to advocate the "right" of the profession to define its own tasks and responsibilities. For example, Elliott and Jacobson [1987, p. 18] asked:

> Should CPAs judge proposed standards primarily by whether they do or do not conform to public expectations...A professional either has expertise and integrity that separates him [sic] from the public or he [sic] does not . . . That does not mean that public expectations are unimportant, only that they should not be the basic criterion used to evaluate proposed auditing standards. The appropriate criterion is whether and to what degree a proposal would improve the effectiveness of audits of financial statements. This responds to the public **need** the profession serves, not to supposed expectations. And needs and expectations can differ. (Emphasis in original)

Although Elliot and Jacobson raised some valid criticisms of the proposed expectation gap standards in the remainder of their article, their basic opposition to the new accounting standards was premised upon disagreement over who should define the roles and responsibilities of auditors. For these authors, auditors should decide the nature and content of the tasks within their professional jurisdiction. In turn, the

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[20]A business bulletin that briefly described the proposal preceding this new requirement indicated that predictions of survivability were "a responsibility auditors have tried to duck until now" [*Wall Street Journal*, December 11, 1986].

public must rely upon (and trust) auditors to assess public needs rather than capitulate to unwarranted public expectations. Yet, the authors did not explicate how one could distinguish between a need and an expectation nor did they suggest any measure by which to evaluate the effectiveness of audits. Instead, they presumed that audits were essential to the economy and were capable of addressing the warranted concerns of the public by continuing on those terms previously established by auditors. In other words, the lay public was to have little role in defining this work or its expected outcomes.

In contrast to the events of the 1970s, critical attention was not deflected from the auditing profession. As the media reported on new corporate failures, questions about the usefulness of audit opinions, and, in particular, questions regarding how financial results could turn sour so quickly after the issuance of a "clean" audit report continued to be raised. Alleged audit failures included Regina Co., Allegheny International Inc., Crazy Eddie Inc., Coated Sales Inc., and American Biomaterials Corp. [*Wall Street Journal*, January 24, 1989]. The ZZZZ Best Co. collapse was thought to provide the ". . . most vivid proof that the present system for independent auditors reporting financial fraud" did not work [Dingell in *Wall Street Journal*, January 22, 1988]. This collapse was particularly troubling as ZZZZ Best had fired one audit firm and hired another shortly before its financial collapse. Although the first audit firm communicated its suspicions of financial misdeeds to the SEC within the allotted time (30 days), this communication occurred after ZZZZ Best had filed for bankruptcy protection [*Wall Street Journal*, January 22, 1988; *New York Times*, January 27, 1988].

The audit profession was also heavily criticized in the press and by Congress, the General Accounting Office and others for its perceived failure to warn the public of the impending savings and loan crisis, a warning some claimed might have reduced the costs arising from the savings and loan bailout [see e.g., *Wall Street Journal*, November 23, 1987; Jacob, 1991; Sternberg, 1992; "Big 6,"*Business Week*, 1992]. The quality of audits was criticized in almost every major savings and loan failure.[21] For example, after the failure of Lincoln Savings and Loan, one regulator commented: "Lincoln is proof positive that any thrift in America could obtain a clean audit opinion despite being grossly insolvent" [*Wall Street Journal*, November 21, 1989] and allegations

[21]Indeed, a GAO report [1989] alleged that auditors had in some instances failed to verify independently management assertions about the collectibility of loans and criticized the quality of several audits that it investigated.

were also made that Lincoln's auditors had approved transactions that were "accounting-driven" in order to generate profits [*Wall Street Journal*, August 7, 1989; November 15, 1989]. Congress held many hearings to investigate these savings and loan failures, at which auditors were frequent witnesses. Audit firms were confronted with numerous lawsuits and paid significant settlements and fines in the aftermath of the savings and loan crisis [see e.g., *Wall Street Journal*, December 30, 1988; January 24, 1989; January 27, 1989; March 2, 1990; February 6, 1991; June 14, 1991; July 5, 1991; December 6, 1992].

In the midst of this controversy and scrutiny, Rep. Wyden continued to advocate legislation to require auditors to report to regulators the uncorrected illegal acts of audit clients and to promote legislation designed to establish an early warning system to prevent future financial debacles such as that which had occurred in the savings and loan industry [*Wall Street Journal*, Sept. 14, 1990, October 5, 1990, August 2, 1991; September 3, 1991; July 29, 1992]. Various versions of this bill continued to be opposed by assorted business groups receiving on again but mostly off again support from the AICPA. This continued opposition occurred within the context of a self-described audit "liability crisis". Audit firms were reported to have expended hundreds of millions of dollars in fines, legal fees and settlements in the wake of the savings and loan crisis and as a consequence of securities fraud class action suits filed after a fluctuation in stock prices. One 1992 commentary estimated that accounting firms faced 4,000 liability suits (twice the number in 1985) and that the largest firms were spending $30 million each year in legal fees [McCarroll, 1992]. Indeed, lawsuits resulted in the bankruptcy of one major U.S. auditing firm in 1990.

Legal liability exposure was now described as the profession's top concern [see e.g., Sternberg, 1992; "Big 6", *Business Week*, 1992; O'Malley, 1993a,b; Lochner, 1993; Epstein, 1993; Fogarty et al., 1994] and it portrayed itself as a scapegoat for bureaucratic errors and investor desires to avoid losses ["Big 6", *Business Week*, 1992; O'Malley, 1993a]. Members of the profession sought liability reform as litigation was increasing ". . . at a rapid rate . . . but that would not be so bad if only incompetent or dishonest auditors were penalized by huge judgments. However, few intelligent observers believe that this is the case" [Lochner, 1993, p. 94], as "unwarranted litigation and forced settlements constitute the vast majority of claims against accountants" [O'Malley, 1993b, p. 84]. In 1992, the Big 6 accounting firms joined a coalition of professional organizations and business, the Coalition to Eliminate Abusive Securities Suits, to lobby in favor of federal legislation to curb "abusive lawsuits alleging securities fraud" [*Wall Street Journal*, September 1, 1992].

This rising incidence of litigation against auditors was interpreted as a search by the public for absolute assurance and as a threat to the ability of the financial reporting system to provide relevant, reliable and credible information. From this perspective, the audit opinion was to be interpreted neither as a "Good Housekeeping Seal of Approval" [McCarroll, 1992; Jacob, 1991] nor as suggesting that a particular company was a worthwhile or safe investment. Public expectations for audits were characterized as spiralling ever upward with regards to their ability to prevent fraud, mismanagement and business failure. Lochner [1993, p. 94] argued that "Far too much weight is being placed on accountants' work, in part because even some businessmen [sic] are ignorant of how audits are performed and what they represent. . . . audits cannot guarantee accuracy or the detection of fraud; they are not insurance policies."

In this environment, auditors expressed concern as to whether legislation such as that proposed by Rep. Wyden would open the door for additional lawsuits against auditors—now by their clients [Silverstein, 1992; O'Malley, 1993a]. Further, some members of the profession began to characterize the necessity for liability reform as inseparable from auditors agreeing to undertake additional responsibilities [e.g., O'Malley, 1993a,b; Epstein, 1993]. This connection was made most explicitly by O'Malley [1993b, p.85] who argued that "any effort on the profession's part to meet these [public] expectations . . . always seems to generate newer and even more unrealistic expectations. . ." [O'Malley, 1993b, p. 85]. He also stated point-blank that "the accounting profession will not support any further legislative expansion of the independent auditor's responsibility without meaningful liability reform—for it is our view that increased obligations that create unreasonable expectations will almost certainly produce increased litigation" [O'Malley, 1993a, p. 7]. In other words, further participation by the public in defining the roles and responsibilities of auditors would carry a price—tort reform.

CONCLUDING OBSERVATIONS

With the passage of the "Private Securities Litigation Reform Act of 1995" [Public Law 104-67], the legal liability concerns of auditors were addressed. This new legislation enacted a system of proportionate liability under which auditors will pay damages based upon the share of fraud for which they are held responsible. In exchange for this protection,[22] the new law explicitly requires auditors to include "procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts", "procedures designed to identify related party transactions . . . or otherwise require disclosure. . ." and "an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year" [Public Law 104-67]. Furthermore, the law places a responsibility upon auditors to provide the SEC with a copy of their report of any illegal acts which have a material effect upon the financial statements when management fails to take "timely and appropriate remedial actions" and the Board of Directors has failed to inform the SEC of such a report within one business day after its receipt from the auditors [Public Law 104-67]. Auditors, in exchange for liability reform, have accepted an affirmative duty to notify regulators of illegal acts in prescribed circumstances. Auditors must still implement the requirements of this legislation and the Auditing Standards Board of the AICPA has issued a proposal providing additional performance requirements to enable auditors to meet their fraud-detection responsibility [*Wall Street Journal*, April 4, 1996].

After decades of vociferous opposition to accepting responsibilities to detect fraud, such a responsibility has now been enacted into law. Throughout much of the period examined in this paper (and before), auditors sought to dominate the definitions of their roles and responsibilities and to equate the conduct of an audit with the production of credible financial reporting. Auditors were no doubt correct in asserting that an audit could not always be depended upon to detect frauds nor to warn infallibly of imminent business failures. However, in defining their roles and responsibilities, they argued that neither of these responsibilities were elements of their tasks (at least prior to the issuance of certain auditing standards in 1988). In part, the failure of auditors to "educate" the public as to the value of an audit that excluded such tasks from their jurisdictional domain arose from cultural values with which audits were aligned. The public refused to accept that despite credible financial reporting significant fraud could remained undetected and corporations could fail soon after a "clean" audit report was issued.

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[22]It was reported that proponents of the bill including the Big 6 auditing firms ". . . spent millions of dollars on a massive lobbying campaign . . ." [*Wall Street Journal*, June 29, 1995] for this legislation.

Auditors had perhaps little choice in terms of the cultural values with which to align their work. While the profession benefited greatly from the Securities Acts, growing rapidly after their passage [McCraw, 1984], it was in another sense limited by these acts. This New Deal legislation did not fundamentally alter either the securities industry or public policy with respect to it. Instead, the legislation seemed designed to restore confidence in the industry and to encourage broad-based stock ownership. The legislation adhered to the "belief that shareholders are 'owners'" who could participate effectively in corporate governance through disclosure and proxy provisions [Merino & Neimark, 1982, p. 39][23] Although shareholders were not expected to participate in the day-to-day operations of corporate enterprises, they would receive information about the uses of funds, earnings, assets and liabilities of corporations. Required disclosures would provide the light ". . . so that ownership may know what is being don with its property" [Andrews, 1932, p. 354]. Auditors were closely linked to these purposes by the requirement in these acts for an "independent" check upon the representations of management and the profession was thereby connected to the provision of credible financial reporting.

The emphasis upon disclosure and financial reports as a means to control management seemed to require a third party to verify these reports.[24] This verification may be seen as an additional mechanism to suggest that measures had been taken to prevent management appropriation of stockholder property. Auditors were to be the intermediaries [Miranti, 1990] between the investing public, the claimed owners of the firm, and possibly avaricious and unscrupulous management. As a consequence, the administrators of the Securities Acts were also dependent upon auditors. This dependence perhaps partially explains why the profession was able to limit its responsibility throughout much of the period examined. While the value of "credible financial reporting" might be used to criticize and question the profession, it also limited the actions of government and closely linked the State, the SEC and the audit profession.[25] No alternatives were posed

[23]Also see Blough [1939], who referred to shareholders as owners of the enterprise, and Ripley [1927].

[24]My thanks to Barbara Merino for her comments which have been integrated in this paragraph.

[25]See Galambos [1982] on the formation of such triocracies.

to replace auditors as monitoring devices for private property. Instead, the emphasis was placed again and again upon either questioning the auditors or upon installing particular techniques to suggest their independence from management. The profession was criticized but never threatened with replacement or extinction.

So we see the development and installation of new self-regulatory practices during the 1970s occurring amidst questions about the responsibility to detect fraud or warn of imminent corporate failures. Similar questions were raised during the 1980s amidst a myriad of corporate failures and frauds (perhaps particularly those in the savings and loan industry). Auditors were again constructed as failing to accomplish the work they had defined for themselves and were confronted with renewed demands to alter their previously self-defined tasks. Even then, the profession was successful in obtaining payment in the form of liability reform in exchange for ceding some control over the definition of its responsibilities. This paper suggests the difficulties of altering such responsibilities for an entrenched and well-organized profession even in instances where the definitions it forwards may starkly contrast with those anticipated or expected by the public.

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